Recommendations on California Capital Formation

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Executive Summary

Project Objectives

The Angel Capital Electronic Network (ACE-Net) is a nationwide Internet-based system that was sponsored by the Small Business Administration Office of Advocacy. ACE-Net was established to improve access to investors for entrepreneurial companies seeking financing in the $250k to $5M range, a range historically served by business "angels" and highly-specialized venture capital investors.

The Goldstrike Partnership is an effort to:

1. Improve access to angel investment for technology-based entrepreneurial businesses,
2. Expand assistance to companies enabling them to qualify for investment,
3. Expand access to industry-specific forums, and
4. Develop an exit strategy for implementing a state-wide network of investors and value-added providers on a self-sustaining basis

Pursuant to these goals, this project sought ideas on how to increase awareness and improve the utility of ACE-Net among angels, angel networks, and other early-stage investors, how to maintain or improve the quality of companies on the system, and how to further fund the ACE-Net program. Under the original project objectives, ACE-Net stakeholders required that action be taken in four primary areas:

1. Informing angel investors about ACE-Net,
2. Maintaining the quality of deals posted on ACE-Net,
3. Attracting corporate investment in companies in the network, and
4. Making ACE-Net self-sufficient.

In investigating this project, we assumed a focus on investors in high-tech businesses that would either be acquired or become IPO, rather than businesses that relied on modest dividend returns for the investor. This is an important distinction, since building businesses in this manner requires a great deal of expertise and capital expense, and may require sophisticated market knowledge in order to evaluate the highest growth paths.

What We Found

We found that the seed-level capital formation for small businesses in California is a process governed largely by:

1. A strong investment focus on high tech, including software, networking, semiconductors, and biotechnology, with regional biases,
2. Investor reliance on established business and social networks to evaluate deals,
3. Increasing sophistication and return expectation of seed round investors, and an increase in the funding capability among California angel investors, and
4. The increase in numbers of service providers (lawyers, accountants, and consultants) and entrepreneurial centers involved in the fundraising process

Furthermore, we found that seed-level investments typically lack business components that are critical to their success, and as a result find it difficult to raise money. There are four critical issues facing small businesses when raising capital at the seed stage:

1. Developing a marketable concept, and a corresponding business plan that shows that a market exists for the proposed product(s) and includes a realistic financial plan,
2. Forming a credible business and technical team,
3. Finding an investor or group of investors in the first place, and
4. Gaining the confidence of the investor(s) once contact has been made

While the ACE-Net system was set up to help these companies address these issues, we found that ACE-Net is not sufficient to meet the needs of entrepreneurs or investors in the following ways:

1. ACE-Net does not model the investment process that most California angel investors employ. A deal on the ACE-Net system starts with an offering of shares at a specific price, whereas angel investors typically source their own deals, share them with people they know can add value, and then negotiate valuations and offering amounts with entrepreneurs. If ACE-Net were to model this process, it would allow investors to place deals on the system, privately circulate them with other investors and value-added parties, and share in increasing levels of due diligence.
2. Most investors want to share due diligence and seed-stage management with other investors, consultants, executives, recruiters, and legal help. The ACE-Net system does not allow non-investing organizations and individuals to add their much-needed value to deals *prior to* and during due diligence.
3. ACE-Net's tie to the SEC scares away many investors. In general, investors in early stage companies steer away from regulated offerings, under the suspicion that dealing with such securities will bring unwanted liability or cost - whether these suspicions are real or perceived.

4. Later-stage investors may view these limitations and restrictions, whether real or perceived, as "deal killers". As such, using ACE-Net is not a priority for them.
5. There are a number of alternatives and substitutions to ACE-Net that are emerging, at the very least causing confusion among the entrepreneurial and investment communities.
6. ACE-Net is under capitalized by a great deal. In the face of competition, it does not have an adequately defined development, maintenance, and marketing budget. The marketing portion of ACE-Net is of particular concern, since both entrepreneurs and investors are not aware of the system's capabilities or successes.

We found that nearly all ACE-Net operators had multiple revenue sources, and that ACE-Net revenues were rather minimal. In at least one case, ACE-Net raised enough concerns that an ACE-Net operator has halted selling the ACE-Net system to their local angel community. Nearly all ACE-Net operators help angels and entrepreneurs get together in private "off-line" discussions on a regular basis, suggesting that a regulated, automated system may not be the best way to catalyze the early-stage capital formation process.

In the state of California, we found that a number of angel investors have banded together in various ways to invest large amounts of money in early-stage ventures, often in amounts in excess of $1 million. The most successful angel groups pool not only financial resources, but also expertise and business contacts. As angel groups become better organized, angel investors and venture capitalists exist in a state of "coop-etition".

Recommendations

At its core, ACE-Net is a technical automated solution to a business problem. Considering the established processes and networks in which seed investors operate, ACE-Net may be an idea ahead of its time, and may take quite of bit of tailoring to be used on a widespread basis. This does not mean it is not a viable solution to the problem of helping entrepreneurs raise money. However, it is a signal that funding of such a system requires a closer look if it is to be truly successful.

What is most important is that the business goals of the Goldstrike Partnership be addressed. The project team therefore recommends one of two possible paths:

1. Allocate significant funding to build a comprehensive solution - sanctioned and guided by the SEC. This report highlights some of the primary characteristics of a potential solution.

2. Abandon the ACE-Net system, and allow ACE-Net operators and stakeholders to pursue economic development objectives through their private sector connections. ACE-Net operators should embrace and do business with automated solutions that meet the needs of entrepreneurs and investors they serve locally.

Either way, public agency stakeholders in ACE-Net should promote public policy and fund private initiatives that not only encourages economic growth through entrepreneurship but also protects investors in early-stage private equities.

Examples of public policy issues the project team believes are beneficial to these goals include tax-free rollovers of capital gains into private equities, public investing in private equity partnerships – making local and regional biases and stage-of-investment biases as necessary, continued support of the SBIC program, and subsidizing incubators.

Specific Exit Strategy for California

The state of California shows a strong bias toward seed-level deal-making in northern California. Seed investing in this region is a well-established practice, and angel investors are becoming increasingly sophisticated.

1. Abandon the ACE-Net system and embrace alternatives such as Garage.com and Offroad. ACE-Net operators such as BARTA and LARTA should continue to find promising seed-stage investments and help them gain audience with angel investors and venture capitalists through their private connections.
2. In order to help entrepreneurs find qualified investors, the state of California should fund an initiative to build an on-line Angel-Entrepreneur-"Related Organizations" "super network" and resource guide. This network would allow entrepreneurs to post business plans – not securities - on the Internet, and give them additional resources they can use to get in touch with would-be investors. Allow third parties to privately circulate the plans to potential investors they already know. Through these existing relationships, deals may consummate.
3. In order to decrease the risk to investors, increase the level of professional investment management (e.g. organized angel networks, professional venture capitalists) capability at seed stages. This can be done by allocating public funds to professional venture capitalists that specifically target seed investing.

Introduction

Project Goals

The Angel Capital Electronic Network (ACE-Net) is a nationwide Internet-based system that was sponsored by the Small Business Administration Office of Advocacy. ACE-Net was established to improve access to investors for entrepreneurial companies seeking financing in the $250k to $5M range, a range typically served by business "angels" and highly-specialized venture capital investors.

The Goldstrike Partnership is an effort to:

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Pursuant to these goals, this project sought ideas on how to increase awareness and improve the utility of ACE-Net among angels, angel networks, and other early-stage investors, how to maintain or improve the quality of companies on the system, and how to further fund the ACE-Net program. Under the original project objectives, ACE-Net stakeholders required that action be taken in four primary areas:

1. Informing angel investors about ACE-Net,
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Assumptions and Project Team Experience

In investigating this project, we assumed a focus on investors in high-tech businesses that would either be acquired or become IPO, rather than businesses that relied on modest dividend returns for the investor. This is an important distinction, since building businesses in this manner requires a great deal of expertise and capital expense, and may require sophisticated market knowledge in order to evaluate the highest growth paths.

Consequently, seed investors investors must be able to invest enough money to build the companies to a stage where they would attract later-stage institutional investors such as venture capitalists, investment banks, mutual funds, and pension funds. This, too, is an important consideration, since many of the seed investors we investigated have developed these types of connections throughout their professional lives.

Throughout the project, it became evident that the seed-level and venture capital investment process– particularly as it is executed in California - was not well-understood by the State of California, and to a lesser extent, the ACE-Net operators. While the intent of this report is not to write a complete dissertation on seed investing, the project team felt it important to educate interested parties on the investment process through this report.

Methodology

In undertaking this project, we have relied upon the team's professional expertise and business network during this project to analyze the shortcomings of the ACE-Net system and to formulate a recommendation for accomplishing the Goldstrike Partnership's objectives. The process entailed the following steps:

1. Analyze the actual requirements of early-stage company stakeholders, including angel networks, seed-stage venture capital firms, entrepreneurial organizations, and public policy groups,
2. Assess in detail the processes required to source, promote, invest in, and track business deals that occur on ACE-Net,
3. Develop extensive partnerships with both not-for-profit and for-profit organizations in the entrepreneurial and investment communities such that minimal investment is required from state and federal sources, and
4. Develop a list of action items that will enable the network of resources to operate efficiently.

The Capital Formation Process

ACE-Net seeks to serve entrepreneurs starting businesses and seed stage investors alike. We believe that the best way to achieve this is to model the capital formation process *as it exists today*, and seek to *facilitate* it through an automated solution, rather than changing the habits of entrepreneurs and investors.

This section of the report highlights our findings on the capital formation process in California, which is an inefficient process governed largely by:

1. A strong investment focus on high tech, including software, networking, semiconductors, and biotechnology,
2. Investor reliance on established business and social networks to source and evaluate deals, including service providers and entrepreneurial centers,
3. Increasing sophistication and expectation of seed round investors,
4. A complicated investment process that is relatively prototypical across most high-tech companies.

From our investigation, we found that many angel investors do not seek out investments. They do, however, allow investments to come to them though trusted filtering channels. It is not apparent that ACE-Net adds a great deal of value to the filtering process. Specific limitations are detailed in the ACE-Net System Overview section of this report.

Seed Investors' Focus on High-Tech

Seasoned investors chase high-growth markets. In recent years, returns on investments in information technology – particularly investments in California-based technology companies - have increased tremendously. Two themes are readily apparent in California's high-tech regions:

1. Investors in and employees of successful high-tech companies have become wealthy in recent years, and represent a new generation of angel investors. This group of angel investors possesses a unique combination of significant funding capability, relevant technology and market knowledge, and current business contacts that enhance the probability of success of new information technology companies in which they invest.
2. There is a high-degree of bias towards seed investing in Silicon Valley-based companies, as opposed to those in Central and Southern California.

Entrepreneurship and Wealth Creation in California

California has developed a knack for breeding entrepreneurship that has led to wealth creation among a large population in comparison with other national high-tech development zones. California's quality higher education system in engineering sciences, in combination with the dismantling of the defense industry in the 80s, successful high-profile high-tech companies of the 70s, 80s, and 90s, and the use of innovative stock options packages for employees has created wealth for the founders, executives, and employees of successful companies.

In recent years, "start-up fever" has run strong in Silicon Valley. Thousands of "Internet millionaires" have been created in the past five years. Some of these new millionaires have founded or invested in new companies, hoping to invest in the next high-flying company.

While the abundance of capital has been good for high-tech capital formation at the seed stage, it has led to an overabundance of early-stage companies satisfying the same market needs. Many of these early-stage companies go out of business when the initial investment - and even follow-on investment from venture capital firms - runs out. The

One important message is heard among seasoned venture capital and public-market investors. The high-tech sector has been a highly cyclical investment sector over the past twenty years, and is highly dependent on the level of IT spending among Fortune 500 companies. Global recessions and near-recessions in the early and very late 80s, resulted in low returns or complete loss of money for investors in early-stage high-tech companies when IT spending was cut back.

A similar phenomenon was seen when the public markets lost faith in the biotech sector in the mid-80s and stock values lost over 50% of their value in a short period of time. Given the recent run-up in valuations of Internet-related companies, investors in early-stage companies should be sophisticated enough to understand that these segments are risky investments.

Regional Biases

The high-tech industry has strong regional biases towards the types of businesses invested. The Silicon Valley region has developed a highly unique entrepreneurial culture for semiconductors, system software, and networking systems. Southern California area has a higher proportion of multimedia, healthcare, biotechnology, and manufacturing businesses.

In recent years, high-profile Internet and networking companies have captured the attention of public market investors, and generated large returns. As a result, there is a strong bias towards investments in these areas – and Silicon Valley companies have a better chance to attract the right talent in these companies.

Investor Reliance on Established Networks to Source and Evaluate Deals

While seed investors vary in their understanding of the risks involved in investing in early-stage companies, many of them are becoming increasingly sophisticated in their understanding and approach to investing. Angel investors, while keenly enthusiastic at the prospects of high returns, seek to minimize risks by:

1. Researching and adding value to companies in which they invest. Because this research can be time-consuming, angel investors rely on people they know to screen and evaluate deals in which they invest. Alternatively, angel investors will invest in businesses in which they can add a great deal of value under the belief that their personal involvement in a new venture will result in increased value.
2. Pooling financial and business resources of like-minded angels (through angel networks)

The first investment round is risky for both the investor and the company. However, because of the early-stage nature of the companies and the low valuations they command, the potential for company growth and valuation growth are enormous. For these reasons, investors want to perform as much market research and valuation validation on the potential investment as possible prior to effecting an investment.

Sourcing and Screening Deals

Angel investors that were successful entrepreneurs and executives not only generate wealth, but also fame, business acumen, and contacts. These contacts include former employees, customers, investors, and other executives. As a result of their own success, these business leaders become the focal point for new business ideas and investment opportunities, and give advice to the next generation of entrepreneurs one way or another.

If an angel investor has produced good returns for investors in the past (particularly if they produced good returns as an entrepreneur), institutional investors will piggyback on their success, expertise, and experience when they become involved with another company. Later stage investors such as venture capitalists, investment bankers, and institutional investors see time and money involvement of these proven leaders as a strong endorsement of the business' market and long-term viability.

There is evidence that many angels invest in opportunities that they know well. Some notable examples:

Company	**Key Angels / Investors**
Netscape	Jim Clark (graphics and networking – SGI)
Pixar	Steve Jobs (multimedia – Apple)
Rambus	Bill Davidow (semiconductors – Intel)
Seibel Systems	Tom Siebel (enterprise software – Oracle)
3DFX	Gordon Campbell (semiconductors – Intel)

Table: Investments by Successful Entrepreneurs

Formation of Angel Networks

Angel investors have nearly always shared potential opportunities with lawyers, accountants, entrepreneurs, executives, and venture capitalists they know in order to evaluate potential investments and minimize the risk of their failure.

Partly due to the retreat of larger, established venture capitalists to later stage investing, partly due to the increasing sophistication required to start a new venture, and partly due to the increased expectations of angel investors to score big wins, angel investors and smaller venture capital funds have begun to formalize these groups in order to share which they can share a further degree of due diligence, financial risk, and value-added resources on deals.

In fact, many angel networks operate as "side funds" to larger venture capital firms. Side funds are small venture capital funds that invest alongside larger institutional funds, typically on a pro rata basis. Limited partners (investors) in these side funds are often executives of the venture firm's current or former portfolio companies. Side funds often give preferential terms to these investors in order to draw upon their expertise as the venture fund makes investment decisions.

Individual angel investors typically wish to remain private and work with people they have known for many years. In contrast, angel groups may want to publicize themselves to entrepreneurs as a way to increase deal flow yet individually remain anonymous to the outside world.

Within angel networks, each investor may receive tens or hundreds of business plans in a single month. From among these plans, investors may choose one or two that meet their base investment criteria, or through the pre-investment value-added efforts of those involved in the angel network, may become a suitable investment. The sponsor then circulates the business plan among the others in the group to solicit feedback and suitability to be presented. This process may take one to three months. Once a critical mass of investors are interested in hearing more, the company is invited to present an overview of the company, the business opportunity, and their funding requirement. Each company typically receives 15 to 30 minutes in which to present. Following this, interested investors evaluate the deal individually or together.

Examples of California angel groups are highlighted in the Section on How Angels and Seed Funds Operate.

Increasing Sophistication Among Angel Investors

While there has been a great deal of press about angel investors that fill the “funding gap”, many California-based angels and angel groups are sophisticated investors and see the participation of venture capital firms in the round immediately following theirs as the only way to ensure that these companies will have staying power.

Investment Criteria

As a result, many angel investors use the same criteria that venture capital firms use in evaluating risky, early-stage investments, and are equally as cautious as - if not more so than - venture capitalists. And not only do California-based angels look for deals at an earlier stage than most venture capital firms, but there is evidence that they also participate alongside venture capital firms even at the later stages. As a consequence, angel investors and venture firms enjoy a fairly close relationship.

Interestingly, both angel investors and venture capitalists have recognized that opportunity that seed investing brings. According to Ann Winblad, partner at Hummer-Winblad Venture Partners, valuations of later-stage and mezzanine round investments have risen substantially in recent years, yet seed valuations have seen very little increase. So, while venture firms are trying to put larger amounts of money to play, they are also looking for very good seed deals.

It is important to note that ACE-Net has not produced a single deal that was backed by a top-tier venture capital firm.

Value-Added Connections

One of the primary criticisms of seed-level companies is that they are lacking in one of the following areas:

1. An objective competitive analysis that includes an assessment of substitute products and a description of competitive barriers.
2. A comprehensive business plan that includes continuous innovation of the product lines, market development, and potential acquisition candidates.
3. A human resources plan for attracting and retaining the right talent.
4. Corresponding financial planning that includes a sensitivity analysis for various plan scenarios.

First time entrepreneurs looking for seed funding typically find it difficult to answer these questions. As a consequence, it becomes difficult to find suitable investment sources. Several organizations and service providers cater to this entrepreneurial need, and host several programs to educate entrepreneurs on business development issues. These are described in more detail in the section Seed Stage Players.

Prototypical Investment Process

Our going-in assumption on this project was that ACE-Net should model the seed-stage investment process. Within the high-tech sector, the funding process is fairly typical. Companies raise capital to expand their business from one stage of development to the next. Sophisticated investors recognize that companies increase in value only by reaching several important milestones throughout the development of the company. In order to limit their risk that a company cannot meet its milestones, investors typically insist on raising a limited amount of money – enough to get the company to the next stage plus some contingency.

For this reason, most high-growth venture-backed companies go through several rounds of financing before going public or being acquired. Investors in early rounds of financing want to be rewarded for the risks they take and want to see higher valuations at each subsequent round financing.

Many angel investors and nearly all venture capitalists are seeking to invest in companies that are developing or serving needs within large, clearly-defined high-growth markets. This usually means that companies serving such needs need to build product lines quickly or launch extensive marketing efforts in order to fend off competition. This also usually means that companies need to bring on substantial amounts of capital in a short period of time to capitalize on market conditions.

The following table illustrates the various stages of financing a company goes through, the primary use of proceeds, the amount of funding source typically sought, and the primary source of capital at that stage.

Round	Use of Proceeds	Amount	Source
Seed	Prove concept/Develop a prototype	\$10k to \$500k	Personal savings, friends and family, angels
Start-up	Build product or service	\$250k to \$2M	Angels, Early-stage venture capital
First-stage	Initiate sales and marketing	\$2M to \$10M	Venture capital
Second-stage	Expand operations	\$5M to \$50M	Venture capital
Mezzanine	Major expansion, Strategic partners	\$10M to \$100M	Late-stage venture capital, Strategic corporate investors
Bridge	Preparation for IPO	\$15M to \$30M	Investment banks, strategic corporate investors
IPO	Major expansion	\$25M to \$100M	Major institutions, “the public”
Secondary Offerings	Major expansion, acquisitions	More than \$50M	Major institutions, “the public”

Table: Prototypical financing rounds

Seed Capital Formation Considerations

The first investment in a start-up company typically come from founders' personal savings, and from their friends, family and "fools" (FFF). However, FFF financing typically covers only nominal expenses like rudimentary office supplies, bank account expenses, company registration fees, and limited amounts of equipment. Early stage companies may also receive in-kind equipment, office space, or consulting services.

Individuals in start-up companies may invest a substantial amount of "sweat equity" before raising their first dollar from the outside. Others may opt to raise capital from the onset. Still others may postpone raising money from outside investors as long as possible in order to increase value, serve customers' needs, or ensure control over the company.

At some point in time, however, entrepreneurs typically find that they are ready to build a substantial prototype, test an initial product with a customer, or bring in additional contacts that only someone from the outside can bring. This usually requires that the entrepreneur add additional engineers and/or a product marketing person. Expanding the team in this manner usually requires a seed round of financing in the $250k to $2M range.

Companies that successfully raise seed financing typically:

1. Have existing established relationships with one or more qualified seed investors,
2. Hire someone that knows potential qualified investors, or
3. Hire a broker that has established a set of investment contacts.

Evaluating and Executing Deals

From among the plans that angel investors see, they may choose a few per year that meet their base investment criteria, or through the value-added efforts of those involved in an angel network, may become a suitable investment. The sponsor of the deal – typically another angel investor – circulates the business plan through among the others in the group to solicit feedback and suitability to be presented. This process may take a day to six months.

Many angel investors will invest only in deals that they believe are attractive candidates for later stage investors. This may be for one of the following reasons:

1. The business requires specific expertise of later stage investors (e.g. customer contacts or experts in exit strategy), and/or
2. The business requires more capital than the early-stage investment group can provide in the long term.

Despite any shortcomings, if significant interest in the investment is generated, a group of potential investors will perform due diligence. This involves interviewing the team, reviewing the prototype in greater detail, calling on customers or potential customers, and analyzing the financials.

If the business appears to solve a verifiable need, and customers appear willing to buy the product or service, investors (in conjunction with their legal counsel) will create a term sheet, which includes:

1. How much money is offered out of the total required,
2. The securities being offered (typically preferred shares),
3. The pre-money valuation of the company,
4. The rights the investors require (liquidation preference, anti-dilution, ratchets),
5. Special terms, such as bringing on specific investors or types of investors that can provide additional value-added capabilities and relationships.

Completing a Transaction

Completing an investment transaction involves a number of steps:

1. **Brokering.** The company may hire a person or organization to handle the fundraising process. Brokers typically receive between 3% and 10% of proceeds raised. This typically exists at later stages of financing, since earlier rounds typically are not large enough to warrant the efforts that brokers put in. That said, there are some consultants that will package early-stage deals in exchange for a combination of retainer fees and warrants for up to 3% of the company (calculated after the investment has been made).
2. **Negotiation**. An offering is formed when the company decides how much money it needs and how much equity it is willing to give to get it. Some companies may simply produce a business plan and leave it to would-be investors to offer a term sheet, while others may develop a private placement in conjunction with a lawyer, broker, or consultant. Venture capital firms typically prefer the former. At early stages of financing, the offering is typically negotiated over a period of time.
3. **Sponsorship**. Sponsorship refers to the practice of a person using his/her personal and professional contacts to refer the company to a potential investor. For companies that have few investor contacts, being “sponsored” by someone or an organization that has validated the viability of business is often the key step in finding an investor. This is particularly true at the seed stage. Investors, particularly wealthy individuals and venture capital firms, have surrounded themselves with people that will refer only the best deals to them.
4. **Due Diligence**. Due diligence is the investigation process employed by would-be investors. Due diligence may include calling customers or potential customers, analyzing competitors or potential competitors, performing a financial analysis, performing a technical analysis of the hardware or software the company expects to build, or executing background checks on the management team.
5. **Transaction**. The transaction is the act of forming the equity deal, negotiating the terms, and wiring the money to the company’s bank account.
6. **On-going Management**. Companies may raise several rounds of financing throughout the course of its lifetime, before an investor “exits”.
7. **Exit**. The “exit” is the process of selling the shares acquired in an equity transaction.

An Example Transaction

The following illustrates how different players come together to execute a transaction.

1. The entrepreneur sends an investor an executive summary, which generates interest from an investor. The investor then notifies the entrepreneur of its interest and requests a more detailed business plan.

2. The entrepreneur sends the investor a longer business plan. If the investor becomes yet more interested, it will then notify the entrepreneur of its interest in performing due diligence and request more information. Some investors will present a term sheet at this stage, saying that it intends to invest "pending due diligence".

   The investor may wish to include other investors in the deal. If so, the investor becomes the lead investor, and either a) requests that the entrepreneur share the same degree of information with the other syndicate investors, meaning that the entrepreneur must go through steps 1 and 2 with these other investors to bring them to the same point in the process as the lead investor, or b) shares the information with other syndicate investors, thus keeping the identities of the other would-be syndicate investors anonymous.

   Common practice within the investment circles is sketchy as best. Most investors will want to "sponsor" a deal, taking the lead in sharing information with other firms, and soliciting input, objections, and interest. GFTV feels that giving the investors freedom to share information among other investors and consultants is crucial functionality for the ACE-Net system.

   Some entrepreneurs may feel uncomfortable with this process. At this stage, it is crucial that entrepreneurs carefully consider whether or not to proceed with investors who request more information, and consider whether or not the two parties can agree on the desired levels of confidentiality. Some venture capital firms, for example, will refuse to sign non-disclosure agreements even at this stage. It is also crucial that investors protect their interests in the deal by requesting whatever degree of privacy and exclusivity they desire (i.e. asking the entrepreneur to withdraw information previously shared with other investors).

3. During the due diligence process, investors will review information provided by the entrepreneur or gather information from outside sources. This information may include product designs, customer surveys, employee agreements, internal memos, and legal documents. Investors will also perform background checks and credit checks on key employees and management. Typically, both entrepreneurs and investors consider the information shared confidential and proprietary, even if no formal non-disclosure agreement is exchanged.

4. The investor may wish to include other investors in the deal. If so, the investor becomes the lead investor, and requests that the entrepreneur share the same degree of information with the other syndicate investors, meaning that the entrepreneur must go through steps 1 and 2 with these other investors to bring them to the same point in the process as the lead investor.

5. By this time, the lead investor will have offered a term sheet, outlining the terms under which it would invest, possibly with an expiration date.

6. The entrepreneur then accepts, negotiates, or rejects the term sheet. If the entrepreneur ultimately rejects the term sheet, the entrepreneur should may request that information

previously provided to investors be returned. The entrepreneur then goes back to step 1 or 2 until a deal with one or more investors is closed. The deal is considered closed when a contract is exchanged and executed, and a financial transaction occurs.

Seed Stage Players

Drivers for Early stage Investing

In the past five years, venture capital investing has attracted enormous attention and capital, and generated terrific financial returns. High-profile Internet and eCommerce companies have experienced multiple years of 100%+ growth, and selected venture investments have achieved 100X or greater returns. Several venture capital firms have experienced aggregate annual returns of 80% or more in the past year, far beyond the historical 16.9%.

According to VentureOne, a leading market research firm on the venture capital industry, venture-backed investments in the second quarter of 1999 far exceeded previous records, totaling a record $6.8 billion, more than double the amount invested in the same period only one year earlier. Furthermore, this amount represents a 45% increase in total venture-backed investments from the previous quarter, showing the continued acceleration of capital into this type of financing activity.

These new records result from continued growth and predominance of Internet and eCommerce investment opportunities, and in particular online business services. Companies such as eBay and Amazon with huge valuations and market caps have seemingly sprung up overnight, and the number of "dot com" companies advertising in your daily newspaper grows larger everyday. With this tremendous growth comes the opportunity for tremendous financial investment and return.

While institutional and corporate venture capital firms finance many startups, angel investors and angel networks have recently been providing more funds to help get new ventures rolling. In fact as successful venture firms grow and gain more funds under management, in order to invest quickly and effectively they are investing larger amounts at later stages. This has recently resulted in a gap of available funds at the initial stages of investment known as "seed round", ranging roughly from $250K - $2M. New, smaller venture firms, as well as angels and angel investment groups, are now filling this gap.

Seed round investment is often required when a company isn't quite ready for a traditional first round investment. It is often the case that a startup company lacks critical requirements to achieve first round funding; however, these requirements could be satisfied with additional time, money, and resources. If the startup can attract a small seed round investment, it might complete key market research, produce a product prototype, fill out the management team, or acquire an initial customer. Any of these might then bridge the gap to traditional first round venture investment.

An example seed round might provide $1M in capital, with an associated startup company pre-money valuation (before investment) at around $3M. The seed round investor would acquire a 25% equity stake[1], and the startup company founders would retain a 75% equity stake. While this is a typical scenario, the terms of this investment might be extensively negotiated before settling on these numbers.

[1] *$1M capital invested + $3M pre-money valuation = $4M post-money valuation; $1M/$4M = 25% equity*

Many other items could also be negotiated, such as the number of seats on the Board of Directors that are taken by the investors, employee agreements for the company founders, vesting of the founders shares, registration rights, co-sale agreements, and warrant coverage among others. These are usually written up in the Term Sheet that summarizes the agreement between the company and the investors.

Ultimately, once a seed round investment has been made, the Entrepreneurs and the Investors are both hoping to be successful in getting to the next round of investment, which often involves a traditional venture capital firm. Angel Investors must be careful to structure the seed round investment terms in such a way that does not preclude later stage investors from wanting to participate. Unusual terms, excessive valuations, or inappropriate equity distribution could discourage later investors from investing.

In some cases, Angel Investors and seed stage venture firms may work with larger venture firms to help create a channel of seed round investments that flow into first round investments, if properly structured and successfully managed. This strategy can be beneficial to both parties by helping larger venture firms handle due diligence and filtering needs, and providing early stage investors with follow-on capital for their ventures in subsequent investment rounds.

The Primary Players

Private equity investments are by nature very risky. Early stage companies have a high potential for failure and offer no liquidity for potentially long periods of time, but because of their early stages of development they have a high potential for growth.

All investors have an asset allocation strategy that assumes a certain level of risk and expected return for each asset class. Investors generally pick a "sweet-spot" for investing - a careful balance of investment risk with potential return while bearing in mind the logistics of investing a specific amount of capital.

To put it in perspective, consider that mutual funds are the most conservative of funds, investing only in the public offerings, where stocks are easily liquidated and risk is lower. Some mutual funds target blue chip stocks, while others may target small caps. In either case, the companies are focused on relatively low risk investments in big publicly traded companies. Smaller funds need higher multiples to get the same return in gross amount. For example, venture capitalists with smaller funds target various stages of private (pre-public) companies to take advantage of higher return potential.

Even still, with the growing size of private equity funds, venture capitalists need to push more money into the pre-IPO market. The balancing act of reducing risk and increasing investment size forces the typical venture capitalist to invest more money at later stages in the private equity rounds. In fact, some new venture capital funds are targeting private placement into undervalued public companies because of the interesting mix between risk and liquid return.

For these reasons, venture capitalists are increasingly targeting companies that are looking for $2M to $5M in first-time funding. According to the PriceWaterhouseCoopers Money Tree Report, venture capital firms are now investing an average of $3.7M the first time they put money into a company. This limits most venture capital firms to investing at the first round of finding because seed rounds are too small for the amount of effort required to complete a deal and work with the company to build it properly.

Angel investors, such as private individuals and seed venture firms, tend to target yet earlier stage companies. It is at these early stages of development that companies need less capital and have the highest expected returns. Some of these investors are uniquely qualified to identify successful companies at earlier stages, and add significant value to investments through strong leadership in business development, marketing, sales, and executive recruitment.

There are several players in the early stage investing game. Fundamentally, there are entrepreneurs and there are investors. Although there are many different types of Entrepreneurs, financially they are simply be grouped together as People with Ideas who need Money[2].

The Investor category also has a number of different types, which we describe below. Primarily there are Angel Investors and Venture Capitalists. In addition to these two basic profiles and variations, there are other facilitators we describe later that may be involved in the relationship between the

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[2] *It should be noted that a growing number of Internet Entrepreneurs who have been successful in previous ventures have significant resources to finance their own seed and first round investments.*

Investor and Entrepreneur. For the purposes of this report, we will focus our attention on the differences between these players based on the size and scope of their financial and other material contributions to the early stage venture.

The chart below describes the general investment range of various types of investors, as well as typical investment amount per deal, and usual focus for round of investment:

Investor	Investment Range	Typical Investment	Investment Round
Entrepreneur	$0 - $100K	$25K	Pre-seed
Angel Investor(s)	$25K - $500K	$100K[3]	Seed
Angel Network	$250K - $2M	$500K	Seed, First
Seed Venture Fund	$250K - $2M	$1M	Seed, First
Institutional Venture Fund	$1M - $20M	$5M	First, Second
Corporate Venture Fund	$5M - $50M	$10M	Second, Later
Private Equity Fund	$5M-$25M	$10M	Later, Pre-IPO
Mezzanine Fund	$20M-$50M	$25M	Pre-IPO

[3] *This amount represents an individual angel's investment, not necessarily total seed round investment*

Entrepreneurs

Entrepreneurs are the people with the business ideas. They make the venture go, and they provide the vision and product and sweat to take the company from startup to maturity (hopefully). Unless they happen to be independently wealthy or flush with cash from a previous successful venture, they are likely looking for money to help get their venture off the ground. In exchange for the Entrepreneur's ideas and effort, they will retain an equity interest in the venture. In exchange for the Investor's financial and other contributions, they will also retain an equity interest in the venture.

In order to gain Investor interest, Entrepreneurs need to prepare a business plan, a brief executive summary, or a slide presentation describing their business concept. These documents or presentation will be used to educate and inform the Investor about the venture, and present a compelling reason why the Investor should risk their capital on the low probability that the company will someday provide a substantial financial return. At a minimum, this information should describe the market, the product or service, the value proposition, the competitive landscape, and the team. It should also outline financial requirements for the first year or two, and key milestones for success to be achieved within that timeframe.

The odds against the Entrepreneur are quite high. For a typical venture capital firm managing a $50-100M fund, the VC partners may look at 1,000 deals a year, talk seriously to 100 of them, and fund 10. Of those, perhaps half will break even or lose money. Perhaps another third may make 1X-5X return on investment; however from the VC perspective this isn't even considered success. Of the remaining investments, the Investor is looking for the 1 or 2 deals that progress to merger, acquisition, or IPO[4] and provide substantial returns on the order of 5X-10X, 10X-50X, or more.

In recent years the amount of capital available and deals being done has increased substantially, as well as the number of firms being acquired and going public. However, the typical Entrepreneur should still expect to have only a 1 in 100 chance of getting funded, and only a 1 in 500 of creating a business that is considered a successful venture investment. On the other hand, for the Entrepreneur who survives the odds of getting funded the chances of getting future investment are quite good. And for the Entrepreneur who makes a substantial return of 5X-10X or better, they are almost guaranteed future Investors will be interested in financing their next venture.

Of course it's always the first time that is the hardest. Many hi-tech entrepreneurs come from a technology background, rather than a traditional MBA or business background, and are not fully aware of the effort required to start and grow a venture-backed company. They are also unlikely to have much financial knowledge, and have little concept or understanding of the investment process or the players involved. It is precisely this situation that the early stage investor is walking into.

[4] *For a select few venture firms in past years, the number of "successful" investments may be substantially higher than the average case noted here, with as many as 50% reaching significant liquidity.*

Angel Investors

Over the past 5-10 years, an alternative to traditional venture capital financing has become quite popular. The Angel Investor is someone who invests between $25K - $500K, with a typical investment of around $50-100K. Angels may invest alone, however it is becoming more common for Angel Investors to form groups and invest together (see "Angel Networks").

There are various types of angel investors, with a range of motivations and interests. One may be a general partner for a venture capital firm who would like to invest outside their firm. Another might be a highly compensated senior executive in the middle or later stages of their career, looking for a new challenge. Still another might be a former entrepreneur who has been successful in a previous venture and has some newly gained capital available, and would like to try their hand at investing. Whatever their origin, the distinguishing factors are that Angels have some significant amount of capital to invest, and a stomach and desire for early stage investing.

Here are several common types of Angel Investors:

- Experienced Venture Investor
- Network of Angel Investors (see "Angel Networks" below)
- Senior Management / Corporate Executive
- High Net Worth Individual
- Former Successful Entrepreneur
- Entrepreneur Family or Friends

There are some interesting trends that are occurring with the Angels noted above. One trend is that Angel Investors with some history or experience coming from the first three groups are becoming more sophisticated, and are beginning to challenge and compete with venture firms in some areas. They are well aware of how the venture finance process works, understand how to perform due diligence, and can write up an appropriately structured term sheet. They also have the luxury of investing when and how they choose, rather than according to a mandated fund schedule, and yet can move quickly to invest when they choose to. These savvy Angels are more and more working together and achieving superior returns, similar to the top venture firms.

Another trend is that Angel Investors are emerging from the latter three groups that have little knowledge of the venture process, few tools to work with in structuring their investments, and limited awareness of how to conduct proper due diligence. They may be enamored with venture investing, and feel overly optimistic with the prevalence of recent above-average returns. Particularly in Silicon Valley, as a result of numerous nouveau-riche former entrepreneurs and startup employees, these investors are becoming much more prevalent. However, they are gradually discovering (the hard way) they have a lot more to learn about early stage investing, and may encounter numerous roadblocks in their ability to work with larger investors to secure necessary later stage financing for their investments.

These two trends illustrate the diversity of early stage investors, and also present a challenge to the entrepreneur in understanding what their investment partner brings to the venture, outside their capital contributions. Even more today, there is a reciprocal need for the Entrepreneur to perform due diligence on the Angel Investor. The acceleration of capital does not always correlate with an acceleration of expertise.

In addition to contributing capital, Angel Investors may take a board seat on the new company, and will likely contribute some amount of expertise to the venture. This may be limited to an occasional monthly or quarterly review of the company's efforts, or it may involve the investor taking an active position in the firm, such as a business development role. In any such situation, this works best when the company founders and the Angel Investor have discussed the role at the same time as when the negotiations for capital investment occurred. In addition to capital, this expertise can be crucial to a startup company's success. On the other hand, lack of expertise or a mismatch on expectations and expertise contributed can result in frustration and failure.

Two other trends that have occurred as a result of the acceleration of angel investment are the formation of local communities of angels investing together (Angel Networks), and also Internet-based communities (Online Angel Networks). We discuss both of these groups below.

Angel Networks

In the past 5 years, a number of Angel Investors have joined together to form investment groups. Some of these have become quite large and well known, such as the **Band of Angels** (over 100 members) and the **Angel Breakfast Club** (~ 40-50 members). Numerous other formal and informal Angel Networks of size 5-50 investors are appearing throughout the country, and are becoming the norm for early stage investing instead of a single Angel operating alone.

While Angel Network investment size may rival that of small VC funds, the structure of their investments is much looser, and typically they do not have a specific fund size to invest or a limited partners arrangement. They tend to invest anywhere from $250K-$2M per deal, and they may also work closely with (and may compete with) traditional venture capital firms to do follow-on rounds of investment.

In most cases, potential investments are sponsored by one or more of the Angel members, and reviewed in an informal setting to gauge interest. After the initial presentation, a more formal set of negotiations may then take place with interested parties. In this regard, angel networks operate differently than traditional venture firms that make decisions in which all partners participate uniformly. In most Angel Networks, it is possible only a few Angels will decide to invest in any particular deal, while others choose to pass and look at the next deal. This allows Angel Investors to review and discuss deals together, and to reduce and diversify their risk by pooling funds from other Angel Investors. It also provides opportunity for Angels to participate in multiple deals more readily, and for Angels with smaller amounts available to invest ($25-50K) to participate in larger deals they would not normally be able to do on their own.

Seed Venture Capital Funds

Due to the recent success of venture capital investing in Silicon Valley, a number of new venture firms have begun to emerge. As traditional venture capital firms raises larger and larger funds of $100M-500M+ and begin to invest larger amounts at later stages, several smaller firms with funds of $20M-100M are filling the gap and investing in early stage ventures. These "Seed VC" funds typically invest $250K-$2M per deal, and have more formal general/limited partner structure and fund management goals than individual angel investors or angel network investment groups

Seed VC firms tend to have more significant involvement in a startup company than a larger size venture firm. As with other early stage investments, it is common for the startup to be missing a few critical requirements for a larger traditional first round financing. Seed VC firms often address this issue by taking or placing a key spot that may be missing on the management team, as they provide a seed round investment. They then assist the startup with "packaging" for a subsequent first round investment. In this scenario, Seed VC firms may be looking for startups that are close to getting a first round investment, but are just a few milestones or key people short of doing so. This provides them with a much shorter and more likely avenue to the next round of investment, thus ensuring the viability of their early stage investment.

As with Angel Investors and Angel Networks, Seed VC firms may work in partnership with (and also still compete with) a larger venture firm to create a channel of seed round investments that move easily up the financing food chain. In some cases, Seed VC firms may even work with traditional institutional venture firms to raise the funds they will be investing, securing an alliance of financial interests.

	Interactive Minds	21st Century Internet Venture Partners	Rocket Ventures
Aggregate funds to invest	$70M	$55M	$20M
# of deals per year	10	20	7
# of firms/investors in deal	1 - 3	1-3	1-4
Size of deals	$500K - $1.5M	$500K - $4M	$250K - $2M
Pre-money valuation	$2M - 6M, ~$3M	$1-4M, ~2.5M	$1-5M, ~$2M
equity stake taken	10 - 40%	10-35%	10-40%

Institutional Venture Capital Funds

Traditional institution-funded venture capital funds tend to focus on first and second round investments rather than seed round investments. The primary factor leading them away from investing in early stage seed deals is time availability. Their objective is to maximize return to their capital pool. Since early stage investments require as much if not more time commitment than later stage deals and since the investment amount is usually several times smaller, the traditional venture capitalist views the return on their time to be low for early stage deals. Even an extremely high return on an early stage investment may make little impact on the fund's performance given the small amount of overall investment allocated to that deal.

Nevertheless, a number of institutional venture capital funds that generally focus on larger and later rounds of financing may place a portion of their investment funds in seed and first stage rounds. These funds face a variety of circumstances and incentives that makes early stage investment an attractive option.

Sometimes the firms active in early stage investing have a large enough staff and extended network to allocate resources to numerous projects. Additionally, their size affords the ability to develop staff with technical and business depth in a variety of enterprise sectors. Often these firms maintain an Entrepreneur-in-Residence (EIR) program, whereby previous entrepreneurs the firms have funded successfully are retained for future efforts. These EIRs may be assigned to assist in early stage ventures, again reducing burn on the partners' time. Though they might not otherwise take on early stage ventures, these firms will likely have an affinity for ventures related to their specific areas of expertise that will persuade them to participate in early rounds, with the expectation they would also fund later stages of investment as well.

The primary incentive of an early stage investment is, paradoxically, often not the return afforded by the early stage investment itself, but the opportunity afforded to control subsequent, larger rounds of investment. Thus, for many institutional venture capital funds, early stage investment serves as a way to incubate companies in preparation for later rounds of financing. To this end, many institutional venture capital funds invest in early stage companies indirectly through investments in seed stage venture capital funds. The seed stage fund provides an adequate return on capital plus a pipeline into potential later stage deals. An example of this would be **Hummer-Winblad Venture Partners** and **21st Century Internet Venture Partners**. Hummer currently has a $300M fund, and helped spawn 21st Century, which currently has a $55M fund.

Another trend emerging in recent years is that institutional venture firms are now much more likely to invest alone than with other firms. This is again as a result of pressure to invest the ever-increasing amount of funds these firms have available. Previously, traditional venture firms would typically invest with one or two other firms to diversify and reduce their risk. However, now the pressure to invest larger amounts (and the reduced risk due to recent excellent returns and improved likelihood of success) has resulted in venture firms going it alone. This has also resulted in a much more secretive atmosphere for venture investing, and less sharing of information on investments between firms than in previous years.

	Draper Fisher	Hummer Winblad	El Dorado

	Jurvetson	Venture Partners	Ventures
Aggregate funds available	$775M	$300M	$240M
# of investments per year	~ 50	~ 20	~ 15
Range of investment	$1M - $5M	$.5M - $4M	$.5M - $4M
% of investments in seed round	13.5%	8.7%	13.9%
Pre-money valuation (seed round)	$2-6M	$1-5M	$1-5M
equity stake taken (seed round)	15-50%	10-40%	10-40%

Source: VentureOne

Corporate Venture Capital Funds

Corporate venture capital funds are typically focused on mature companies and later stage investments, and usually make investments after a venture firm has already been involved in several previous rounds. They tend to focus on companies whose products are likely to be revenue generating, if not already successful in the marketplace. In certain instances corporate venture funds may take notices of a technology or products that are of strategic interest to the corporation. They may make a small number of their investments in early stage companies, although in most cases these investments are likely first or second round investments rather than seed round.

Companies approaching corporate venture firms for capital should consider how corporate venture objectives and modus operandi differ substantially from other sources of capital and, in particular, from institutional venture capital. Whereas the motive of institutional venture capital fund or angel investors is to maximize return on capital, the corporate venture fund frequently operates with a more complex set of motives that may also focus on overall benefits to the corporation and increased market share for their product platforms or services. The corporate venture fund has strategic objectives that may result in somewhat less aggressive financial return objectives.

An example of this is the investment strategy of **Microsoft**. Although they do not have a formal corporate venture fund, Microsoft has made a growing number of investments and acquisitions that have been focused on enhancing their platform functionality and increasing market share. In the mid-90 in particular, Microsoft made equity investments that were intended to bring more and more end users into the Windows and Windows NT operating system environments. An investment in SoftImage (1995) was used to bring nonlinear editing system users from graphic workstation platforms to Windows. As a result of that investment, SoftImage ported their applications from Unix platform to also run on the Windows NT platform.

Corporate venture funds may offer better financial terms versus other types of investors, but may not provide the same non-capital contributions an institutional venture firm may bring. The startup company may find that a key distribution agreement via their corporate investor is critical to their success. On the other hand, the more focused marketing and business development efforts of a traditional venture capital firm may not be available via a corporate venture firm. Due to the strategic nature of the corporate investment, the startup company may have more limited options with regard to corporate partnering or technology licensing, and there may be pressure to move toward or remain with a specific strategic direction or platform. On the other hand, the corporate venture firm may provide broad access to customers or a key partnership that leverage the investment via non-financial means.

It should also be noted that the corporation investment may have an impact on subsequent rounds of financing in situations where institutional venture capital investors demand higher equity positions, greater flexibility, and pure-return based incentives for management. It may also be more likely that a company will reach liquidity only via acquisition by its corporate investor, rather than remaining independent, or selling to another company or later going public.

Another recent trend is that corporations are also investing in non-corporate venture capital firms, and thereby having some influence on traditional venture capital patterns of investment. Microsoft in particular has taken this approach, rather than create its own corporate fund.

	Intel Corporation	Microsoft	AT&T Ventures
Aggregate funds available	$450M	N/A	$345M
# of investments per year	~ 100	~ 20	27
Range of investment	N/A	N/A	$2M - $5M
% of investments first round	19%	9%	18%

Source: VentureOne

Seed Stage Catalysts

In the past few years, a number of new players have arrived on the early stage investing scene. Several are variations of typical angel or venture investors, however they are all relatively new in their approach to investing and innovative in what they offer. This chart outlines the basic services they offer, and we describe them in further detail below.

Player	Specialty or Service Offered
Venture Brokers & Venture Catalysts	Investor matching & introduction services, packaging for investment, mgmt team placement
Online Angel Networks	Internet-based investor matching & introduction services, online information & resources
Venture Incubators	Shared office space, leasing, administrative services, financial services, HR services, telecommunication & hosting services.
Venture Integrators	Product prototyping and information systems consulting / technology consulting
Internet Investment Banks & Underwriters	Internet-based IPOs and private equity financing services

Venture Brokers & Venture Catalysts

Another form of early stage investment may occur via the Venture Broker, also known as a Venture Catalyst. These individuals or organizations provide matching and introduction services for Entrepreneurs to various venture firms or Angel Investors.

The Broker filters access to venture investors based on the appropriate level of the Entrepreneur and their potential. Often, the Broker has a close relationship with several venture firms or investors and is intimately aware of their particular investment interest or focus. The Broker will typically perform outsourced due diligence on behalf of the venture capital firm, and can provide leverage for the venture firm by pre-qualifying the Entrepreneurs (or by turning away inappropriate candidates). Compensation for the Broker's services is usually via some combination of equity and cash, involving anywhere from 1-10% of equity or a $5-25K flat fee.

In some cases, the Broker may spend significant time and effort working with the Entrepreneur on their business plan and/or executive summary in order to get the presentation to a level appropriate for introduction to the venture firm or other investors.
This type of Broker, sometimes known as a Venture Catalyst, may function as a business consultant, and will likely provide advice to the Entrepreneur or "packaging" of the deal in exchange for equity compensation as noted above and/or hourly consulting fees billed at ~$150-300/hr. For equity-based compensation, services are often performed on contingency based on closing an initial round of investment.

The role of Venture Catalyst is often played by seasoned entrepreneurs or executives who may not have the money to invest directly themselves, but who have the necessary credibility, experience, and connections to help get a venture funded. In certain cases they may also participate in a venture they feel has significant merit, and join the venture in a management team role or board member.

Frontier Ventures (www.frontiervc.com) is a venture catalyst founded in 1997 that provides management assistance and access to funding for promising hi-tech startups. Frontier works with several venture capital sponsors: Canaan Partners, Vanguard Venture Partners, Red Rock Ventures, and Crystal Internet Venture Fund. Frontier acts as an intermediary for these venture capital firms, and helps connect appropriate startup companies with managing partners of these firms.

Frontier provides management assistance in the following areas: 1) strategic planning and business modeling, 2) outsourced financial management, and 3) general team building and operational assistance. Frontier may play a role as a temporary CFO or Controller to outline and execute on a sound financial plan. This plan may include venture capital fundraising, establishing corporate partnerships, and day-to-day financial and operational management.

Online Angel Networks & Internet-based Matching Services

Another more formal and structured version of Angel Network has taken shape over the Internet, offering a set of online services usually performed by Angel Networks and other venture service providers. These Online Angel Networks provide a mechanism for Entrepreneurs to register their business plans, and offer Angel and Venture Capital investors who subscribe to the service access to and due diligence of these deals via the web over the Internet. The most prominent & well known of these is **Garage.com**.

Garage.com was founded in the spring of 1998, with the express mission to attract and match entrepreneurs with angel and venture investors via the Internet. Garage.com offers web-based online services that provide advice, research, reference materials, and forums for both entrepreneurs and angel investors. Garage provides pre-screened investment opportunities that match stated investor interests in appropriate startup companies. Although introductions may initially be made online, deals are typically negotiated offline, via traditional face-to-face methods.

Garage has a number of “Entrepreneur Development Managers” that work with entrepreneurs who have submitted and registered their business plans. These development managers help filter deals and provide due diligence. Deals that pass muster are graduated to “Heaven”, where they are available for review by angel investors and venture capital firms that are registered with Garage. There are two levels of Heaven: the more select area is known as “The Portfolio”, and a less exclusive area is known as “The Exchange”.

Since opening last year, Garage has placed over 20 early stage investments. Garage currently has a network of several hundred angel investors, and approximately 20 venture capital and 20 corporate venture firms. Deals fall in the range of $1M - $4M investments, although a number of angel investors may co-invest at smaller amounts. If a deal is matched via the Garage network, they receive compensation in two ways: 1) Garage receives a percentage of the funds invested, typically around 5%, and 2) Garage has the opportunity to co-invest in the same round and terms, at ~5% of equity.

Several other companies are emerging with similar models for registering, screening, listing, and matching early stage investment opportunities with interested angel investors. Among these are Austin-based **Seedstage.com,** Seattle-based **NVST.com**, and Chicago-based **Vcapital.com** (also known as **Venture Capital Online**). This category is filling up aggressively in regional locations around the country, although all appear to have national aspirations.

Venture Incubators

The role of the incubator is to provide basic infrastructure so that an early stage venture can move out of the home to a functioning office and R&D environment, without expending scarce financial resources and management time. Traditional incubators offer a variety of services, such as leased space, administrative, clerical, financial management, outsourced recruiting, and connectivity through a centralized location where the venture co-locates. As well, incubators may provide technical expertise, business advice and access to potential partners and capital. By joining the incubator, the venture may also receive a credibility boost. Significant economies of scale are realized by providing these services to a group of ventures, typically between 5 and 25, housed at the incubator.

Incubators are often sponsored or co-sponsored by regions or states seeking to attract and nurture high technology companies at their most needy stage. Sometimes corporations, trusts and foundations are sponsors. Depending on the incubator's policies and objectives, the venture may be asked to pay a nominal fee or provide equity or equity incentives. More often than not, the cost of the resources provided by the incubator is significantly below what other sources, especially venture capital providers, would charge. Many incubators "charge" between 10 and 20% of capital stock and do not impose onerous terms upon their venture clients.

This element of public support is justified on the premise that the success of hi-tech companies fostered by the incubator creates significant benefits to the public through future tax revenue, employment and the development of high technology zones. It is also premised on the reality that many early stage ventures are unable to attract capital via other channels and might never have a chance to succeed without this channel.

Recently, a special category of Incubators has emerged focused specifically on Internet businesses. These Internet Incubators typically provide hosting, high-bandwidth connectivity, security, and other Internet support services. This is particularly useful for dot-com ventures that are being incubated in expectation of launching a major online business or service, and reduces complexity and time to market for these ventures.

The **Panasonic Internet Incubator (PII, www.panasonicincubator.com)** is a facility for 10 to 15 Internet and eCommerce start-ups and emerging businesses. In addition to office space, PII provides entrepreneurs with access to a number of shared resources such as telecommunications, web hosting services, and administrative/clerical services. PII also provides access to a network of venture advisors and venture service providers such as lawyers, accountants, bankers and consultants. A unique characteristic of this high-tech incubator is that PII is directly linked to a corporate venture equity investment fund, Panasonic Ventures. This fund's primary function is to further strengthen the bond between a startup company and Panasonic.

Often an early stage venture has a great idea, but lacks the technical expertise and product prototype necessary to get to the first level of funding. In this case, the founding Entrepreneurs may decided to outsource some of their technical product development and work with a consulting firm or systems integrator, sometimes called a **Venture Integrator**, to build their initial prototype.

Previously, this has usually been done for a cash fee. However, many of these early stage entrepreneurial customers don't always have the funds to pay for their projects. As an alternative, some integrators have recently decided they will participate for a reduced fee if they can take an equity stake as well. Since their consulting fees may cost anywhere from $100K-$1M, they are likely to take an equity stake in the venture of 20-30%, comparable to an Angel Investor or early venture round, albeit with some premium since they are also providing the scarce technical resource as well.

Internet Investment Banks & Internet Underwriters

The past few years have seen the creation of a group of investment banks, which differentiate themselves from traditional investment banks by their focus on the technology sector and use of the Internet as a primary client communication conduit. These investment banks, which include **Wit Capital**, **E*Offering**, **Direct Stock Market** and **OpenIPO**, seek to provide similar debt and equity underwriting services as well as equity research that traditional investment banks provide, but without the overhead and constraints of traditional investment banks. They seek primarily to attract clientele and distribute information to clients via the Internet. Currently, they focus on capital provision services for the IPO and secondary offering markets and are not involved in pre-IPO financings. It is possible these investment banks will develop services targeting pre-IPO and even seed stage companies in the future.

Offroad Capital is providing capital provision services to non-public companies. Offroad evaluates business plan proposals and provides its high-net worth private investors access to potential investments, as well as a marketplace to buy, sell and establish fair value for their private equity interests. Currently, Offroad is not primarily active in the seed stage arena, focusing on companies with more established businesses and investments in the range of $3M – $15M. However, in the future, seed stage companies also be targeted.

Offroad provides a number of interesting services via its Internet site. For registered member investors, Offroad delivers a variety of information on private companies seeking early and later stage funding. Among the type of information offered is background info on the company, their business plan, bios of company founders, company financials, and an investment offering. In addition, Offroad delivers investor roadshow presentations via RealAudio and RealVideo that offer a unique remote interactive experience for online investors with sufficient high-speed access (ISDN and greater speeds). They also provide an auction mechanism for setting price on their offerings. The availability of this information to a remote audience provides greater access to a large retail investment community that has previously not had significant entry to private equity offerings. It is likely using the Internet as a method of presenting companies to potential investors will become much more common in the future.

	Offroad Capital	OpenIPO	WIT Capital	E*Offering
Deal Management	Lead	Lead	Co-Lead	Mostly Co-Lead
Investment Focus	Pre-IPO	IPO	IPO	IPO
Investment Range	$4M-$25M	$10M-$30M	$20M-$100M	$10M-$50M
Valuation Method	Auction	Auction	Assessment	Assessment

User Groups and Not-for-Profit Organizations

There are a number of user groups and non-profit organizations that support the entrepreneur and investment community. These groups have no particular monetary interest in early stage ventures, and simply exist to provide education, promotion, and networking opportunities for entrepreneurs, investors, and other related entities.

The **Software Development Forum (SDF)** is a Silicon Valley non-profit organization dedicated to the information, connection, and education of software development professionals and software entrepreneurs. SDF has over 1500 paid members, and supports a community of ~5000 software developers and entrepreneurs. In addition to a number of monthly technical and business user groups (SIGs or Special Interest Groups) that meet on a variety of subjects, SDF holds many seminars and events on business entrepreneurship, sales & marketing, and finance topics. They also provide "VC one-on-one" meetings, a regularly occurring opportunity for entrepreneurs to present their business plans to venture capital firms and get feedback. In addition, they have porting and testing labs for software developers to use, business conference rooms, and a library of technical and business information.

The **Silicon Valley Association of Software Entrepreneurs (SVASE)** is a non-profit organization that meets monthly to facilitate the creation of hi-tech business ventures, and provide a forum for entrepreneurship and exchange of related ideas. SVASE has over 300 paid members and supports a community of ~2000 entrepreneurs. SVASE conducts a monthly dinner meeting with 3-4 speakers that review a topic of interest related to hi-tech entrepreneurship. SVASE topics cover a range of subjects, focusing mainly on early stage financing, marketing, and management issues for hi-tech startups. SVASE meetings are also a premium networking opportunity for entrepreneurs to hobnob and meet with angel investors and some venture capital firms.

Round Zero is an exclusive, invitation-only organization that draws a similar audience to SVASE and SDF, although with a slightly higher caliber of entrepreneur. Many of the founders come from the **Stanford Graduate School of Business**, and a number of the participants are entrepreneurs who have been venture funded previously, as well as prominent venture capital partners who also attend. The group is currently ~70 people. A significant amount of time is spent exchanging business cards and networking, followed by a sit-down dinner with tables of 5 or 6 people discussing a specific topic of interest. Viral marketing via the Internet was the subject of a recent meeting.

The **Churchill Club** is a Silicon Valley organization that conducts 3-4 monthly events reviewing various subjects of technology, investment and other Silicon Valley public affairs. Participants tend to come from the investment, legal, and financial professions, with entrepreneurs also represented. A panel of speakers typically discuss a topic or trend of interest, and attendance is anywhere from 200-1000 people. Speakers are often high-visibility individuals; previous speakers have included Bill Gates, Esther Dyson, Larry Ellison, and John Doerr.

Service Providers Targeting Seed stage Companies

Finally, in addition to the taxonomy of various entrepreneurs, investors, and other related entities we have described, we present one remaining category of self-interested parties. The companies, the "not-so innocent bystanders", do not invest directly in early stage ventures themselves yet profit quite well from such investments. We liken these companies to the enterprising souls who sold picks and shovels and Levis jeans during the Great San Francisco Gold Rush – while certainly not risk takers, they benefit greatly from the risks and investments made by others.

Internet Data Center and Hosting Services, such as **Exodus** and **AboveNet** provide high-bandwidth internet access, top-notch security, and web server hosting services to numerous dot-com startups and Internet businesses that receive venture investment. Many internet startups benefit from industrial-strength infrastructure for their online businesses, and often they outsource this function to such companies in order to reduce their time to market and increase their ability to scale under peak demand. These hosting companies, venture-backed themselves, gain most of their revenues from the infrastructure expenditures of other venture-backed startups that run Internet and eCommerce websites or portals. Typically hosting providers do not invest directly in their customers, however they may provide discounted services to startups that will grow into large future customers. In select cases, they may even place strategic investments via capital or services for startups they see as promising.

Venture Banking Services

Silicon Valley Bank (SVB), along with other venture banking companies such as **Comerica**, and **Imperial Bank**, provide banking and financial services almost exclusively for emerging and hi-tech venture-backed companies. They also serve as a hub for many other venture service providers in various areas such as legal services, human resources mgmt, office leasing, and related services.

Venture Legal Services

Venture Law Group (VLG) is a law firm specializing in legal services for the hi-tech venture-backed market. Like other well-known firms such as **Wilson, Sonsini, Rosati, & Goodrich** that offer venture-oriented legal services, VLG advises investors and startup companies conducting investment negotiations and venture investments. They also provide legal representation for mergers & acquisitions, IPOs, and related services.

Venture Reporting services

VentureOne is a leading market research firm on the venture capital industry. VentureOne offers an extensive online reporting service called **VentureSource**, which provides detailed financial information on recent venture capital investments and venture-backed companies, as well as the venture firms themselves. The service is offered at $10-25K per year to venture firms and other financial service companies. VentureOne also provides various market research publications and an annual conference on the venture capital industry.

Venture Leasing services

Comdisco is a venture and leasing firm that provides capital and equipment for venture-backed companies. In addition to traditional venture financing, Comdisco provides a variety of leasing and other financial services for discounted purchasing of new equipment, used and reconditioned equipment, disaster recovery services, network management and design services, integration services, and a proprietary, high-speed, nationwide ATM data communications network.

Recommendations for ACE-Net

This section reviews the ACE-Net business as it operates today, and highlights where it does not meet the needs of its target audience.

ACE-Net System Overview

Business Purpose

ACE-Net is intended to be an Internet-based national marketplace for the securities offerings of small businesses. Sponsored and funded by the SBA Office of Advocacy, it seeks to reduce the regulatory burden for private equity offerings less than $5M in size.

ACE-Net is an Internet-based system that provides a limited set of tools and sample deals for entrepreneurs and investors alike. Development is performed and the system is maintained by the University of New Hampshire. The main web pages viewed by entrepreneurs and investors are included in the Appendix.

Business Model

ACE-Net is locally managed by network operators, non-profit university-related or state-based organizations that provide mentoring to entrepreneurs and accredited investors. The ACE-Net business model is simple: 39 regional ACE-Net operators encourage entrepreneurs and/or investors a nominal fee to post and view private equity opportunities.

ACE-Net operators generate revenues by charging entrepreneurs and/or investors for the privilege of finding one another, whether deals are executed or not. As such, ACE-Net operators are also its primary marketers.

Because there are few investors or entrepreneurs signed onto the system, ACE-Net revenues are rather minimal. However, all ACE-Net operators have multiple funding or revenue sources, including state and university grants or fees from venture capital conferences they organize.

Regulatory Constraints

ACE-Net and the SBA work closely with the SEC and state securities regulators via their national trade association North American Securities Administrators Association (NASAA) in order to ensure compliance to securities regulations.

In doing so, the sponsoring parties have developed several restrictions for offerings. These are well published on the ACE-Net web site.

Competition

A number of alternatives to ACE-Net have begun to materialize. These competitors are outlined in the section Seed Stage Players. In our opinion, this competition has confused both entrepreneurs and investors alike to the point where paying a fee to register a business plan or paying a subscription looking at investments without knowing the benefits of doing so is a risky proposition.

Single-layer subscription-based business models have seen limited success on the Internet. We recommend that if additional ACE-Net funding becomes available, that alternate business models be evaluated. Some of these include: modest transaction fees for getting deals completed, advertising revenues, and multiple subscription layers.

Specific Limitations of ACE-Net

The major objections to the ACE-Net system revolve around having a critical mass of quality companies and quality investors actively using the system. Entrepreneurs complain that few investors exist on the system or that they are not responsive, especially compared to other channels. Investors claim that deals are not "quality", citing poorly-defined market opportunities, improbable liquidity, insufficient growth potential, and unseasoned entrepreneurs/management.

In our view, ACE-Net places too much emphasis on helping entrepreneurs find funding, and too little emphasis on providing tools that investors can use to better evaluate and share deals. Put bluntly, potential investors don't need more deals from ACE-Net; they need tools that can help them evaluate their current deal flow and share the opportunities with other angels.

Most network operators are concerned about the level of inactivity on ACE-Net. In at least one case, ACE-Net raised enough concerns that an ACE-Net operator halted selling the ACE-Net system to their local angel community. Nearly all ACE-Net operators help angels and entrepreneurs get together in private "off-line" discussions on a regular basis, suggesting that a regulated, automated system may not be the best way to catalyze the early-stage capital formation process.

Even if a critical mass of quality companies and investors were found on the system, ACE-Net suffers from additional regulatory constraints. While ACE-Net operators have some of the skills required to make recommendations to prospective investors, they are not registered broker-dealers, and – through the "No Action Letter" - are expressly prohibited by the SEC to decline applications and screen the offerings for investors.

Furthermore, the SEC Short Form prohibits companies from raising more than $1M in a given 12-month period. Most high-potential investments are in companies that are exhibit high growth rates. As a consequence, the "best" deals will undoubtedly find it necessary to raise larger amounts of capital. Very few company executives, angel investors, and venture capitalists would lock themselves into a deal where growth is limited by the amount of financing.

From initial sign-on to the system, ACE-Net system asks entrepreneurs to price their shares from the beginning and create a public registration of a private offering. Not only does this scare off potential investors (e.g. if the entrepreneur has not priced them fairly), but also locks the entrepreneur into a confusing SEC registration process and announces critical product or financial information to potential competitors, thereby reducing the attractiveness of companies to investors seeking proprietary competitive advantage.

It is our belief that ACE-Net should be based on the existing process of seed investing as described in this document. Through our findings, we found that ACE-Net has missed the mark in modeling this process in the following ways:

1. ACE-Net attempts to give entrepreneurs the ability to market private equity directly to investors. However, the investment process usually involves many people that the investor relies upon the "qualify" the opportunity an entrepreneur presents: brokers, business consultants, investment advisors, fund managers, lawyers, accountants, etc. Throughout this

process, the “term sheet” – `that is, the pricing of shares, and the rights given investors – will certainly change in order to suit both parties.

2. In many respects, ACE-Net puts the cart before the horse: an entrepreneur registers a company’s stock, setting the price and terms from the beginning. By contrast, most private equity deals start with an executive summary of the business and a business plan, and only when there is sincere investor interest, do the parties begin to determine pricing and specific terms.

In order to match this process, the ACE-Net *business* needs to be overhauled to allow brokers, business consultants, investment advisors, fund managers, lawyers, accountants, etc. to *qualify, package, and present* opportunities to investors on the system.

It is the belief of the project team, however, that such overhaul is not only too costly for the SBA to undertake, but that there are several private-sector alternatives that do a better job of helping entrepreneurs than ACE-Net. Garage.com and Offroad are notable examples, as are not-for-profit organizations that have similar goals to ACE-Net stakeholders: the Software Development Forum and incubators.

Primary Functionality for an Enhanced ACE-Net System

In talking with would-be investor-participants in ACE-Net, we found that a number of seed investors and angel groups are interested in a set of tools that allowed them to better qualify opportunities within their existing process.

Should the SBA or other agencies feel that emerging private-sector alternatives do not meet public sector objectives, and should these agencies provide adequate funding for ACE-Net, we propose that ACE-Net include the following functions at a minimum. These recommendations are not exhaustive– it is only meant as a guide – as it is outside the scope of this document to fully detail the functions of a new system.

Automate the Existing Investment Process

It is clear from our analysis that a system which models the investment process must allow entrepreneurs to share varying levels of detail with investors that show increasing levels of interest. As the deal is moved from the "interest" stage to the stage where a deal is struck, a number of events are initiated by either the entrepreneur or investor to move the deal along. The details of this process were outlined previously in this document.

Taking into account the lessons learned over the project, the objections of potential investor-participants in ACE-Net, and the SEC rules for raising capital, the following major changes should be made to ACE-Net before it can be considered as a widespread alternative to the (non-automated) way of sourcing and evaluating investments:

1. Deals must be shared in a verifiably private setting among potential investors that have an existing relationship
2. Deal-specific investment groups must be able to form quickly and include trusted value-added parties that contribute to the due diligence process
3. Each investment group must be able to configure its own deal-sourcing and evaluation parameters, such as investment categories, documents they wish to see throughout due diligence, discussions among potential investors, opinions of experts, and term sheets

For example, when an investment opportunity comes to a seed investor from a trusted source, the investor will work with the trusted source to understand their reasons why they think it is a good investment. Discussion threads that allow potential investors to share and gather addition knowledge of the market, the team, and the technical feasibility of the proposed business with people they know to possess such knowledge over a period of time would be useful in evaluating investment opportunities.

Note that there is concern that the "No Action Letter" prevents ACE-Net operators from performing this role, and under current SEC regulations and ACE-Net caveats, it is questionable whether anyone other than registered broker-deals can use ACE-Net to accomplish this.

Remove Regulatory Burdens

Any automated system should be clear as to how it limits their liability, protects their rights, and allows the companies in which they invest grow in value and raise money rapidly.

One of the major advantages to raising private capital is that both companies and investors avoid the costs and complexities associated with meeting SEC regulations. While ACE-Net goes to great strides in streamlining this, the rules are still too restrictive for the best investment opportunities.

We propose that ACE-Net removes the requirement for entrepreneurs to register securities. If ACE-Net is changed to allow companies to simply post business plans and other information about their business – and investors to find them – ACE-Net becomes a facilitator for sharing information, not a brokerage. While it is the hope that deals are consummated because entrepreneurs and investors found one another on ACE-Net, in reality, deals will be negotiated in private settings.

Common Formats

While it would be stretch to say that all business plans and investment opportunities submitted to the system should be of a "standard" format, most investors look for roughly the same information as they perform due diligence on deals. This information includes:

1. An executive summary of the business
2. A business plan, including:
   - A vision for the company
   - An analysis of the business problem being solved, including specifically what is solved, the size of the market, customer and potential customer list
   - A description of products and services of the company, including what stage of development they are in
   - Descriptions for each member of the management and/or founding team (resumes if possible)
   - Summary financial projections
3. Due diligence support documents (if available)
   - Company strategy documents
   - Market analyst reports
   - Competitive analysis
   - Customer lists
   - Reference lists
   - Background checks
4. Confidential and proprietary documents (if available)
5. Term sheets, which are offers to purchase equities in the company

Privacy and Exclusivity

The system must protect both the business and legal interests of both entrepreneurs and investors. Generally, this means that entrepreneurs should dictate who and who does not see critical operational details. For example, investors should not be allowed to see whether or not entrepreneurs have shared information with other parties and entrepreneurs should not be allowed to see information exchanged among investors.

The system should assure that investors can attain a high degree of exclusivity if they wish to pursue a particular deal. While it is the ultimate responsibility of the entrepreneur to determine if they want to give up the right to share their company's deal to numerous investors, entrepreneurs should be warned that many investors do not like deals that are "shopped" around.

Highlights Value-added Skills of the Players

The system should allow entrepreneurs to find value-added resources such as lawyers and business consultants easily, and show investors what resources the entrepreneur has used or is using. This gives the investor the ability to do reference checks, obtain additional information about the potential investment, and become more comfortable with the company.

Tracking and Monitoring

The system should allow investors to track the growth of their investments as subsequent rounds of financing take place. We suggest a tie-in with VentureOne or PriceWaterhouseCoopers' MoneyTree.

Technical Requirements

<u>Security</u>

The system should be absolutely secure from outside intrusion and allow only authorized individuals to use the system. Administrative procedures should be clear.

<u>Ease of Use</u>

The system should be easy to use by both entrepreneurs and investors. Advanced graphical user interface design techniques should be employed.

<u>Open Interfaces</u>

The system should allow investor groups to link themselves together if they so desire. The system should be designed to allow this.

Other Issues

Professional money managers such as venture capitalists are dedicated to finding and placing money in deals. It is important to note that the success of these professionals depends entirely on getting the best deals sent to them. Furthermore, they have an obligation to their investors to invest it in the most attractive deals, should they get the opportunity. In some cases, investment partnership agreements may even prohibit general partners to "give up" opportunities to the "competition".

Consequently, larger money managers such as venture capital firms are reluctant or restricted to let other investment groups see their deals, under the philosophy that if they see something good, then they have enough skill, expertise, contacts, and money to make an investment successful. For the most competitive deals, investors may quickly offer a term sheet and an intent to invest "pending due diligence". If the company accepts such a term sheet, they are usually restricted to offer the deal to another party or to accept other offers for a stated period of time.

In order to attract these types of investors, ACE-Net should pay particular attention to the privacy considerations outlined in this document.

Summary of Recommendations

At its core, ACE-Net is a technical automated solution to a business problem. Considering the established processes and networks in which seed investors operate, ACE-Net may be an idea ahead of its time, and may take quite of bit of tailoring to be used on a widespread basis. This does not mean it is not a viable solution to the problem of helping entrepreneurs raise money. However, it is a signal that funding of such a system requires a closer look if it is to be truly successful.

What is most important is that the business goals of the Goldstrike Partnership be addressed. The project team therefore recommends one of two possible paths:

1. Allocate significant funding to build a comprehensive solution - sanctioned and guided by the SEC. This report highlights some of the primary characteristics of a potential solution. In order to do this, ACE-Net stakeholders should:

    - Secure funding.
    - Re-deploy the ACE-Net system with additional functionality based on actual requirements gathered from entrepreneurs and seed investors.
    - Use a select few angel groups, value-added consultants, and entrepreneurs in a pilot test in order to identify additional functionality and demonstrate success.
    - Develop a marketing program that reaches out to both entrepreneurs and investors.

2. Abandon the ACE-Net system, and allow ACE-Net operators and stakeholders to pursue economic development objectives through their private sector connections. ACE-Net operators should embrace and do business with automated solutions that meet the needs of entrepreneurs and investors they serve locally. Public stakeholders should:

    - Determine what non-system alternatives to ACE-Net exist in accomplishing their business goals,
    - Determine specifically what industry sectors and regions require the most assistance,
    - Determine non-system methods of linking entrepreneurs to the resources required to build their companies and to ensure they know how to build for the institutional venture capital or public equity markets

Specific Actions for California

In the absence of funds to further the ACE-Net system, the project team recommends that The Office of Strategic Technology and BARTA:

1. Immediately re-state the work efforts of this project by detailing areas where additional information is required to support the business goals outside of an automated system,
2. Documenting what additional education is required for investors and entrepreneurs alike, and
3. Integrating subsequent recommendations with those of other Goldstrike Partners.

Alternatives to an Automated ACE-Net System

Public agency stakeholders in ACE-Net should promote public policy and fund private initiatives that not only encourages economic growth through entrepreneurship but also protects investors in early-stage private equities.

Examples of public policy issues the project team believes are beneficial to these goals include tax-free rollovers of capital gains into private equities, public investing in private equity partnerships – making local and regional biases and stage-of-investment biases as necessary, continued support of the SBIC program, and subsidizing incubators.

1. Build or help build an Angel-Entrepreneur "SuperNetwork". Create a national SuperNetwork of angel and entrepreneur groups by linking groups that operate independently. Many angel and entrepreneur groups act locally. But nearly all rely on the skills of their individuals members. Some of these individual groups use the Internet or a technical solution to communicate both externally and internally. Over a period of time, the best practices of these groups can be shared among groups.

2. Continue the SBIC Program. The SBIC Program has been successful in recent years. However, there is a general feeling among institutional venture capital circles that the SBIC program is a regulatory burden and that SBIC funding is not value-added money for the entrepreneur. Whether this is valid or not, the SBIC program does appear to help bring more capital to the early-stages of companies' growth than if the program did not exist. If any improvements were to be made to spur the capital formation process, it would be to designate higher amounts of SBIC funding to early-stage venture capital firms.

3. Invest in Early-Stage Venture Funds. With the retreat of many venture capital firms to later stage deals, an opportunity exist for several early-stage venture capital funds. Many of the established firms do not do this because the number of venture firm partners increases at a slower rate than the amount of capital they raise, and because smaller, early-stage deals require as much partner time to monitor as larger, later-stage deals. As a result, partners in the most experienced firms are not able to focus their attention on "difficult" early-stage deals and funds. If the California Investment Committee were to create a fund of funds that would invest in early-stage funds, they key things they should look for in funds are newer, well-connected funds rather than large, more established funds.

Appendix – Reference Web Sites

Angel Groups & Angel Networks

Angel Breakfast Club	www.angelbreakfastclub.com (?)
Angels Forum	www.angelsforum.com
Angel Investors	www.svangel.com
Angeltips.com	www.angeltips.com
Band of Angels	www.bandofangels.net
Bay Angels	www.bayangels.com
Garage.com	www.garage.com
NVST.com	www.nvst.com
Seedstage.com	www.seedstage.com
Venture Capital Online	www.vcapital.com

Seed VC Firms, Venture Capital Firms & Venture Catalysts

Interactive Minds	www.interactiveminds.com
Frontier Ventures	www.frontiervc.com
Draper Fisher Jurvetson	www.dfj.com
El Dorado Ventures	www.eldoradoventures.com
Hummer-Winblad Venture Partners	www.hummerwinblad.com
Labrador Ventures	www.labrador.com
Mohr Davidow Ventures	www.mdv.com
ONSET Ventures	www.onset.com
Redleaf Venture Management	www.redleaf.com
Redrock Ventures	www.redrockventures.com
Rocket Ventures	www.rocketventures.com
Tech Coast Angels	www.techcoastangels.org
21st Century Internet Venture Partners	www.21vc.com
500 Hats	www.500hats.com

Other Resources for Entrepreneurs

American Entrepreneurs for Economic Growth	www.aeeg.org
AllBusiness.com	www.allbusiness.com
Asia Tech Venture	www.asiatechv.com
Exodus Communications	www.exodus.net
Forum for Women Entrepreneurs	www.fwe.org
Microsoft Silicon Valley Development Center	msdn.microsoft.com/svdevcenter/svdc_index.htm
Onvia.com	www.onvia.com
Panasonic Digital Concepts Center	www.panasonicincubator.com
Red Herring Magazine	www.redherring.com
Round Zero	www.roundzero.org
Silicon Valley Assoc. Software Entrepreneurs	www.svase.org
Silicon Valley Bank	www.svb.com
Software Development Forum	www.sdforum.org
Stanford/MIT Venture Lab	www.vlab.org
Stanford Univ. Ctr for Entrepreneurial Studies	www-gsb.stanford.edu/ces
Startups.com	www.startups.com
Upside Magazine	www.upside.com
Venture Capital Resource Library	www.vfinance.com
Venture Law Group	www.vlg.com
Wilson Sonsini Goodrich Rosati	www.wsgr.com

Other Resources for Investors

Buck's	www.buckswoodside.com
The Churchill Club	www.churchillclub.org
The Enterprise Network	www.ten-net.org
E*Offering	www.eoffering.com
International Angel Investors Institute	www.angelinvestors.org
National Venture Capital Association	www.nvca.org
Offroad Capital	www.offroadcapital.com
Venture One	www.ventureone.com
Wit Capital	www.witcapital.com
W. R. Hambrecht & Co. / Open IPO	www.wrhambrecht.com, www.openipo.com